

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF WOOD CREEK WATER)
DISTRICT, OF LAUREL COUNTY,)
KENTUCKY, FOR APPROVAL OF) CASE NO. 9594
CONSTRUCTION, FINANCING AND)
INCREASED WATER RATES)

O R D E R

IT IS ORDERED that:

1. The Staff Audit Report for Wood Creek Water District ("Wood Creek") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. Wood Creek shall have until the close of business September 30, 1986, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 16th day of September, 1986.

PUBLIC SERVICE COMMISSION


For the Commission

ATTEST:

Executive Director

**COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION**

APPENDIX A

**STAFF REPORT
ON
WOOD CREEK WATER DISTRICT
CASE NO. 9594**

**PREPARED BY: JEFF SHAW
PUBLIC UTILITIES
FINANCIAL ANALYST**

**STAFF AUDIT REPORT ON
WOOD CREEK WATER DISTRICT**

PREFACE

On May 28, 1986, Wood Creek Water District ("Wood Creek") filed its application in Case No. 9594 seeking approval of construction, financing and increased rates for water service. The proposed rates were designed to generate additional revenues of \$86,359 on an annual basis, which represents an increase of approximately 12.5 percent above the revenues generated by Wood Creek's existing rates.

In order to shorten and simplify the processing of this case the Commission chose to perform a limited financial audit of Wood Creek's operations for the test year, calendar year 1985. The Commission's objective was to reduce the need for written data requests, decrease the time necessary to examine the application, and therefore, decrease Wood Creek's expense related to this application. Mr. Jeff Shaw of the Commission's Division of Rates and Tariffs performed the audit on July 30 and 31, 1986, at the office of Wood Creek in London, Kentucky.

SCOPE

The scope of the audit was limited to obtaining information to determine whether the operating expenses reported in the test year were representative of normal operating conditions and to evaluate the pro forma adjustments proposed in Wood Creek's application. Supporting documentation for expenditures charged to test year operations was reviewed, including invoices and payroll

records. Insignificant or immaterial discrepancies were not pursued and are not addressed herein. The findings and recommendations included in this report do not pertain to Wood Creek's proposed construction or financing nor do they relate to the design of Wood Creek's proposed rates.

BACKGROUND

Wood Creek is one of four water utilities operated from a central office in London, Kentucky, the other three being West Laurel Water Association ("West"), East Laurel Water Association ("East") and Laurel County Water District No. 2 ("Laurel No. 2"). Wood Creek and Laurel No. 2 share an office staff made up of six people. Wood Creek and Laurel No. 2 each have an outside staff which does the physical labor such as maintenance, construction, etc. West and East have no employees: all office, maintenance and construction services are provided to these utilities by Wood Creek and Laurel No. 2.

Wood Creek performs all office, maintenance and construction services for West while Laurel No. 2 performs the same services for East. Wood Creek bills West at a rate of \$2.30 per customer per month for office services and records these revenues in Account No. 474, Other Water Revenues. Wood Creek bills West for maintenance and construction services based on the actual costs incurred for materials, equipment use, labor and overhead costs. These revenues are recorded in Account No. 415, Revenues from Merchandising, Jobbing and Contract Work.

West, East and the City of London, Kentucky, are wholesale customers of Wood Creek. During the test year Wood Creek

generated over \$240,000 from sales of 300 million gallons to these wholesale customers.

FINDINGS

Operation and Maintenance Expenses

In the course of the audit, the staff examined Wood Creek's cash disbursements journal and various invoices related to the test period level of operation and maintenance expenses. Although Wood Creek proposed no pro forma adjustments, the staff's examination revealed some areas in which adjustments are necessary. The staff found no material discrepancies in the level of test period expenses. For those expenses and accounting practices questioned by the staff, the following recommendations are made, along with the adjustments recommended by the staff to reflect the Commission's established rate-making practices.

For the test year Wood Creek reported \$22,661 as expense for Outside Services Employed; for the previous year this expense was \$6,194. An examination of the invoices submitted to Wood Creek by its consulting engineer revealed that \$15,000 in charges for services related to the construction of the 20-inch water main proposed in this case was charged to expense. This cost should properly have been capitalized, rather than recorded as an operating expense, and depreciated over the life of the asset. For rate-making purposes the staff recommends that this cost be amortized over 50 years, which is the useful life used by Wood Creek for water mains. This amortization results in an adjustment to reduce test year operating expenses by \$14,700.

Wood Creek proposed no adjustments for increases in Insurance Expenses. However, a review of Wood Creek's insurance policies and related invoices shows that increases have been incurred for workmen's compensation as well as liability and automobile insurance, during and after the test year. The staff recommends that these increases be reflected in a pro forma adjustment which will increase operating expenses by \$13,359.

The Commission has traditionally disallowed depreciation on plant that has been acquired through contributions as an expense for rate-making purposes. During the course of the audit the staff found no evidence that the Commission should change this practice. Therefore, the staff recommends that a reduction of \$54,467 be made to Wood Creek's test year depreciation expense to reflect the Commission's traditional rate-making practices.¹

Wood Creek had two major projects under construction at the end of the test year which have since been completed. These projects, which included the expansion of Wood Creek's treatment plant and the construction of a new tank and a 10-inch water line, increase plant in service by \$1.1 million and were financed entirely with debt (zero contributions). Based on Wood Creek's current depreciation rates, the addition of these items of plant

¹	Test Year-End Contributions	\$1,856,666
	Test Year-End Plant In Service	\$4,340,450
	Percentage of Contributed Plant	42.79%
	Test Year Depreciation Expense	\$ 127,319
	Percentage of Contributed Plant	X .4278
	Depreciation on Contributed Property	\$ 54,467

will result in an increase of \$40,150 in Wood Creek's annual depreciation expense. The staff recommends that this increase be reflected for rate-making purposes.

If the construction of the proposed 20-inch line is approved Wood Creek's non-contributed plant in service will increase by \$600,000 which would result in additional depreciation of \$12,000 annually. Pending approval of the proposed construction, the staff would recommend inclusion of this expense in the determination of Wood Creek's revenue requirements.

During the test year Wood Creek's water loss was 16.18 percent. The Commission has traditionally allowed a maximum loss of 15 percent in determining revenue requirements. Based on an analysis of the variable pumping and treatment expenses, i.e. - electricity and chemicals, the staff recommends an adjustment of \$2,235 be made to reduce these amounts for rate-making purposes to reflect the maximum allowable water loss of 15 percent.

Accounting and Management Practices

Wood Creek presently bills West at a rate of \$2.30 per customer per month for "office services" which includes meter reading, billing, collecting, bookkeeping and accounting services. This charge is intended to cover labor costs, office supplies, office rent and insurance, office utilities expenses and transportation costs for meter reading services. Wood Creek personnel indicated that the \$2.30 rate has not been changed for several years although many of these costs have changed. The staff would recommend that Wood Creek review its costs related to these office services and determine whether its rate of \$2.30 is

fully compensatory. After the initial review Wood Creek should periodically evaluate the adequacy of the rate it charges West for these services.

Wood Creek bills West for maintenance and construction services based on the actual costs incurred, including overheads. However, for accounting purposes Wood Creek does not include the overheads in Account No. 416, Expenses of Merchandising, Jobbing and Contract Work, but leaves them in the various labor accounts in its books of account. The effect of this treatment is to give the appearance that Wood Creek earns a profit on these services (the net difference between the revenues reported in Account No. 415 and the expenses reported in Account No. 416) when the amounts charged are intended to recover only the costs incurred. The staff recommends that the full costs related to these services including overheads be charged to Account No. 416 and thereby net the revenues and expenses to zero.

SUMMARY


Based on the staff's recommendations contained in this report Wood Creek's adjusted operating statement would appear as follows:

	<u>Wood Creek</u> <u>Pro Forma</u>	<u>Recommended</u> <u>Adjustments</u>	<u>Staff</u> <u>Pro Forma</u>
<u>Operating Revenues</u>			
Water Sales	\$ 693,741	\$ -0-	\$693,741
Other Revenues	71,315	-0-	71,315
Total	<u>\$ 765,056</u>	<u>\$ -0-</u>	<u>\$765,056</u>
<u>Operating Expenses</u>			
Sources of Supply	\$ 301	\$ -0-	\$ 301
Pumping Expense	69,093	<1,410>	67,683
Treatment Expense	159,568	<825>	158,743
Transmission and Distribution Expense	105,811	-0-	105,811
Customer Accounts	107,053	-0-	107,053
Administrative and General Expenses	86,416	<1,341>	85,075
Depreciation Expense	127,319	<2,317>	125,002
Taxes	824	-0-	824
Total	<u>\$656,385</u>	<u>\$<5,893></u>	<u>\$650,492</u>
Operating Income	108,671	5,893	114,564
Other Income	<u>65,474</u>	<u>-0-</u>	<u>65,474</u>
Income Available for Debt Service	<u><u>\$174,145</u></u>	<u><u>\$ 5,893</u></u>	<u><u>\$180,038</u></u>

Based on the approval of the proposed construction project Wood Creek's average annual debt service will increase to \$237,540. Based on the adjusted test period operations, Wood Creek's adjusted Debt Service Coverage ("DSC") is .76X. The staff is of the opinion that this coverage is inadequate and fails to meet the requirements of KRS 278.030. The staff is further of the opinion that a DSC of 1.0X to 1.2X is necessary to allow Wood Creek to meet its operating expenses, service its debt and provide for reasonable equity growth. The additional revenue requested by

Wood Creek would produce a DSC of 1.12X which should be adequate to meet its financial needs. Therefore, the staff recommends that Wood Creek be allowed to increase its revenues by \$86,359 which is the full amount requested. Should the Commission fail to approve the proposed construction the staff would recommend an alternative increase of \$38,528. This would produce a DSC of 1.2X on Wood Creek's existing debt service after eliminating the \$12,000 in depreciation expense on the proposed construction project.

Respectfully submitted,


Jeffrey S. Shaw
Public Utilities Financial
Analyst